

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 ROME 0515/1

LIMDIS

E.O. 11652: GDS
TAGS: EFIN, IT
SUBJ: STATUS OF IMF AND EC LOAN NEGOTIATIONS

PASS FRB

1. SUMMARY. FOLLOWING WERE MAIN POINTS DISCUSSED BY EMBOFFS
WITH TREAS DIRGEN PALUMBO AND BANK OF ITALY DIRGEN ERCOLANI
AT MEETINGS ON JANUARY 12: 1) ON FISCAL PART OF STABILIZATION
PROGRAM, MINTREAS STAMMATI REMAINS STRONGLY DETERMINED THAT CREDIT
TO FINANCE TREASURY CASH DEFICIT MUST NOT EXCEED PROPOSED 9,800
BILLION LIRE CEILING FOR 1977 AND THAT ANY ADDITIONAL EXPENDI-
TURES MUST BE COVERED BY NEW REVENUES. 2) PROSPECTS FOR EVENTUAL
AGREEMENT ON FAIRLY LARGE LABOR COST PACKAGE ARE STILL UNCERTAIN,
BUT SITUATION NOT DESPERATE.
3) WHILE EC COMMISSION IS CRITICAL OF SIZE OF PROPOSED DOMESTIC
CREDIT EXPANSION CEILING, IMF SEEMS LESS PREOCCUPIED, AND
AGREEMENT SHOULD BE POSSIBLE. 4) RELATIVE STRENGTH OF LIRA IN
EXCHANGE MARKET REFLECTS BOTH SHORT-TERM CAPITAL INFLOWS AND
SLOWDOWN IN ECONOMIC ACTIVITY. WHILE BACKLOG OF FOREIGN EX-
CHANGE DEMAND MAY NOT BE MASSIVE, IMF STANDBY, EC LOAN AND
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SHORT-TERM SUPPORT WILL STILL BE NEEDED TO PROTECT LIRA AND TO
PERMIT RESUMPTION OF GROWTH LATE IN 1977. 5) COMPLETION OF IMF
NEGOTIATIONS SHOULD TAKE PLACE AROUND END-JANUARY OR EARLY
FEBRUARY, AND EC COUNCIL OF FINANCE MINISTERS SHOULD APPROVE
LOAN TO ITALY OF PROCEEDS FROM JOINT BORROWING AT ITS MID-
FEBRUARY MEETING. END SUMMARY.

2. TREASURY DEFICIT. EMBOFFS RAISED QUESTION WITH PALUMBO OF ALLEGED CASH BUDGET EXPENDITURES WHICH MAY HAVE TO BE MADE IN 1977 FOR WHICH FINANCING HAS NOT YET BEEN PROVIDED. PALUMBO CALLED ATTENTION TO TABLE ILLUSTRATING SUCH EXPENDITURES WHICH WAS PUBLISHED IN TURIN'S LA STAMPA JANUARY 12. (PALUMBO IMPLIED THAT TREASURY WAS SOURCE OF INFORMATION.) TABLE SHOWS TOTAL FIGURE OF 7,490 BILLION LIRE OF SUCH POSSIBLE UNCOVERED EXPENDITURES. (STAMMATI HAS PREVIOUSLY SUGGESTED THAT HIGH PRIORITY EXPENDITURES FROM THIS LIST TOTALED ABOUT 2,500 BILLION LIRE.) IN ANY CASE, PALUMBO SAID THAT MINISTER STAMMATI WAS ABSOLUTELY DETERMINED THAT PROPOSED 9,800 BILLION LIRE TREASURY CREDIT CEILING FOR 1977 SHOULD NOT BE BREACHED AND THAT NEW REVENUES WOULD HAVE TO BE APPROVED TO COVER ANY ADDITIONAL EXPENDITURES. APART FROM POSSIBLE INCREASE IN VALUE-ADDED TAX, PALUMBO WAS RELUCTANT TO ACCEPT NEED FOR PERSONAL INCOME TAX RATE INCREASES AS SUGGESTED BY LABOR UNIONS. HOWEVER, HE DID CONCEDE THAT "SOMETHING" FURTHER MIGHT HAVE TO BE DONE IN AREA OF INCOME TAXES.

3. LABOR COSTS. PALUMBO WAS SURPRISINGLY OPTIMISTIC ABOUT POSSIBILITY OF EVENTUAL ACCEPTANCE BY POLITICAL PARTIES AND LABOR UNIONS OF SOME MEASURE TO DIRECTLY LIMIT FULL APPLICATION OF SCALA MOBILE IN 1977. HE INSISTED THAT THERE WAS A GREAT DEAL OF PUBLIC POSTURING GOING ON (MOTIVATED BY REAL CONSTRAINTS) BUT THAT, IN FINAL ANALYSIS, SOME COMPROMISE COULD BE REACHED BEYOND EXISTING PARTIAL BLOCK OF SCALA MOBILE AT UPPER INCOME LEVELS, SOME FISCALIZATION OF BUSINESSES' SOCIAL COSTS, AND SOME LIMITATIONS ON COMPANY LEVEL WAGE NEGOTIATIONS. PALUMBO THOUGHT THAT POSSIBILITY OF CHANGING FREQUENCY OF SCALA MOBILE

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ADJUSTMENTS FROM QUARTERLY TO SEMI-ANNUALLY IS NOT VERY GOOD. HOWEVER, IT MIGHT BE POSSIBLE IN SOME OTHER WAY TO REACH AGREEMENT TO LIMIT APPLICATION OF SCALA MOBILE TO LESS THAN EXPECTED 25-27 POINT INCREASE. REPORTEDLY (FROM OTHER SOURCES) GOI WORKING GROUPS ARE EXAMINING VARIOUS POSSIBILITIES SUCH AS: (1) SKIPPING FEBRUARY AND MAY ADJUSTMENTS, (2) REDUCING EACH QUARTERLY ADJUSTMENT BY HALF, (3) REVISING SCALA MOBILE BASKET, (4) SUBSTITUTING COST-OF-LIVING INDEX (WITH ITS DIFFERENT WEIGHTS) FOR PRESENT SCALA MOBILE INDEX, (5) IMPOSING INCOME TAX EQUAL TO LIRA EQUIVALENT OF 10 POINT SCALA MOBILE WAGE ADJUSTMENTS FOR FEB/APRIL QUARTER WITH SIMILAR ONE-TIME INCOME TAX TO APPLY TO NON-WAGE INCOME, (6) EXTENDING TO ALL WAGE EARNERS FOR SAME THREE-MONTH PERIOD EXISTING PARTIAL BLOCK OF SCALA MOBILE, (7) "FISCALIZING" SOME PART OF SCALA MOBILE ADJUSTMENTS TO BE FINANCED BY VALUE-ADDED TAX INCREASE, AND (8) LIMITING EACH QUARTERLY ADJUSTMENT TO NO MORE THAN FOUR POINTS IN 1977. (THE LATTER WAS MENTIONED BY PALUMBO.) THESE VARIOUS PROPOSALS WOULD REDUCE LABOR COSTS IN RANGE OF 2,00-5,500 BILLION LIRE, OR FROM ABOUT 2 TO 5.5 PERCENT OF ANTICIPATED 1977

LABOR COSTS. PALUMBO SEEMED OPTIMISTIC THAT GOI MIGHT PRESENT TO PARLIAMENT AROUND END-JANUARY EITHER DECREE LAW HAVING IMMEDIATE EFFECT (BUT SUBJECT TO PARLIAMENTARY RATIFICATION IN 60 DAYS), OR ORDINARY DRAFT LAW FOR PARLIAMENTARY APPROVAL WHICH WOULD ADOPT EVENTUAL COMPROMISE ON LABOR COST BASED ON PRIOR ACCEPTANCE BY LABOR UNIONS. HE THOUGHT IT ESSENTIAL TO STRIKE WHILE THE IRON WAS HOT, SINCE ITALIAN PUBLIC AND LABOR UNIONS THEMSELVES ARE STILL IN MOOD TO ACCEPT REASONABLE SACRIFICES. DR. ERCOLANI WAS NOTABLY LESS OPTIMISTIC ABOUT POSSIBILITY

NOTE: LIMDIS CAPTION ADDED PER ROME 568.

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OF REACHING COMPROMISE ON NEW SCALA MOBILE MEASURE.

4. MONETARY CEILINGS. PALUMBO CONFIRMED THAT RELATIVELY LITTLE ATTENTION HAS BEEN GIVEN BY IMF RECENTLY TO EVENTUAL ESTABLISHMENT OF MONETARY CEILINGS. FUND WAS STILL CONCENTRATING ITS ATTENTION ON FISCAL AND LABOR COST QUESTIONS. PALUMBO WAS OPTIMISTIC THAT IMF WOULD ACCEPT DOMESTIC CREDIT EXPANSION CEILING OF ABOUT 30,300 BILLION LIRE. HE ADMITTED THAT EC COMMITTEE FAVORED LOWER CEILING OF AS LITTLE AS 25,000 BILLION LIRE. HOWEVER, HE DID NOT SEE HOW GOI COULD ACCEPT SUCH A LOW LIMIT WITH ZERO GROWTH ALREADY PROJECTED WITH THE CEILING AT 30,300.

5. FOREIGN FINANCING AND FOREIGN EXCHANGE MARKET.

DR. PALUMBO MENTIONED THAT HE WOULD ACCOMPANY PRIME MINISTER ANDREOTTI TO BONN FOR HIS MEETINGS WITH CHANCELLOR SCHMIDT ON JANUARY 17-19. ONE IMPORTANT OBJECTIVE OF VISIT WOULD BE TO EXPLAIN TO GERMANS PROGRESS MADE BY GOI IN ITS STABILIZATION EFFORTS AND TO SEEK UNDERSTANDING OF LIMITS TO WHICH GOI COULD REALISTICALLY GO WITH REGARD TO LABOR COST QUESTION. DR. CONFIDENTIAL

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ERCOLANI DENIED PRESS REPORTS WHICH CLAIMED THAT ANDREOTTI WOULD SEEK AGREEMENT FROM GERMANS TO CONVERT PRESENT SIX-MONTH GOLD LOAN INTO MEDIUM-TERM GOLD LOAN. HE SAID THAT WITH REGARD TO IMF FINANCING, GOI HOPED THAT ITS STABILIZATION PROGRAM WOULD WARRANT STANDBY OF MORE THAN MINIMUM SDR 450 MILLION, AND HE PRESUMED THAT IMF WOULD ALSO BE WILLING TO EXTEND REPAYMENT SCHEDULE FOR \$830 MILLION REPAYMENT ON 1974 STANDBY WHICH FALLS DUE IN 1977. ERCOLANI SAID THAT THERE HAD NOT BEEN MUCH DISCUSSION WITH FOREIGN OFFICIAL LEADERS ABOUT POSSIBILITY OF RE-SCHEDULING SOME OF OFFICIAL CREDITS WHICH PEAK IN 1978.

6. DR. ERCOLANI WAS PLEASED WITH PERFORMANCE OF LIRA IN EXCHANGE MARKETS SINCE BEGINNING OF DISMANTLING THE PRIOR DEPOSIT SCHEME AND THE 7 PERCENT FOREIGN EXCHANGE TAX. HE ATTRIBUTED GOOD PERFORMANCE IN LARGE PART TO SHORT-TERM CAPITAL INFLOWS IN FORM OF SUPPLIER CREDITS AND COMMERCIAL BANK LOANS. HOWEVER, HE ALSO BELIEVED THAT SLOWDOWN IN ECONOMIC ACTIVITY AND DRAWDOWN OF IMPORTED INVENTORIES WAS ALSO BECOMING IMPORTANT FACTOR, NOTWITHSTANDING HIGH NOVEMBER LEVEL OF IMPORTS AND INDUSTRIAL PRODUCTION. BOI HAD STUDIED POSSIBLE AMOUNT OF FOREIGN EXCHANGE BACKLOG WHICH MIGHT BE OVERHANGING EXCHANGE MARKET PENDING REMOVAL OF PRIOR DEPOSIT AND EXCHANGE TAX. HE THOUGHT THAT OVERHANG OF SUPPLIER CREDITS MIGHT BE ABOUT \$600-700 MILLION BUT HESITATED TO GIVE FIGURE FOR TOTAL OVERHANG, INCLUDING SHORT-TERM BANK DEBT. HE DID SEEM TO ACKNOWLEDGE THAT EMBOFF'S SUGGESTED BACKLOG IN RANGE \$1200-1800 MILLION WAS REASONABLE ESTIMATE AND THAT THIS WOULD BE "TOLERABLE" FIGURE GIVEN LEVEL OF ITALY'S RESERVES. ERCOLANI ALSO THOUGHT THAT ITALY'S CREDITWORTHINESS IN FOREIGN MARKETS WAS IMPROVING AND THAT FAIRLY HIGH SHORT-TERM BANK CREDIT EXPOSURE MIGHT CONTINUE. NEVERTHELESS, HE HOPED THAT ADEQUATE SHORT-TERM FINANCING FACILITIES WOULD BE AVAILABLE TO MEET TEMPORARY PRESSURE ON LIRA. ALSO, IF ECONOMIC RECOVERY BEGINS IN LATE 1977, THERE WOULD LIKELY BE NEWER ADDITIONAL FINANCING.

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7. TIMING OF IMF AND EC NEGOTIATIONS. DR. PALUMBO WAS HOPEFUL THAT GOI WOULD BE READY TO CONCLUDE NEGOTIATIONS OF IMF STANDBY AROUND END-JANUARY. HE HOPED THAT IT WOULD NOT BE NECESSARY EITHER FOR ITALIAN MISSION TO GO TO WASHINGTON OR FOR IMF MISSION TO GO TO ROME, BUT HE DID NOT PRECLUDE THE LATTER. DR. ERCOLANI WAS LESS WILLING TO CITE A DATE ON WHICH IMF NEGOTIATIONS MIGHT BE CONCLUDED BUT SAID THAT THERE WOULD BE A NEED FOR A FINAL IMF MISSION TO ROME. DR. PALUMBO DID NOT EXPECT EC COUNCIL OF MINISTERS OF FINANCE TO APPROVE RE-LENDING OF \$500 MILLION FROM JOINT BORROWING AT ITS SCHEDULED JANUARY 17 MEETING. IN FACT, HE SEEMED TO QUESTION WHETHER MEETING WOULD BE HELD AT ALL. INSTEAD, EC APPROVAL OF JOINT BORROWING SEEMED MORE LIKELY AT MID-FEBRUARY MEETING OF FINANCE MINISTERS.VOLPE
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